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Green With Envy? Greenmail is Good! Rational Economic Responses to Greenmail in a Competitive Market for Capital and Managers

*Eric Engle**

ABSTRACT

“Greenmail” denotes the decision by a corporation’s board of directors to repurchase its shares that are held by a corporate raider, often at a significant premium, thereby keeping the board of directors in office. It may represent a conflict of interest between the corporation’s shareholders and the board of directors. While greenmail is legal, 50% of greenmail gains are subject to taxation. This Article argues that greenmail has a healthy role in a competitive market economy.

I. INTRODUCTION

A corporate raider purchases a significant number of shares of a stock on the public market, driving the price of the stock upward. The raider then offers the company the chance to buy back his shares at an even higher price — or face the prospect of a hostile takeover, sale of assets, and new management. Management buys back the raider’s shares at a higher value than on the public market. The raider sells their shares. The price of the stock on the open then market falls. Is there anything wrong in this scenario? Before you answer — what if management did not buy back the raider’s shares? Suppose that the raider then tried to take over the company driving the public price of the shares even higher. Is there still something wrong? What if the raider fails to take over the company? What if the raider succeeds? When we see all the different basic scenarios, the impossibility of a quick clear answer becomes apparent: here, one more variable, what if the company is poorly managed?

This practice of forcing a choice between a premium share repurchase and the threat of a takeover is called “greenmail,” a term used to contrast the substance of the transaction from “blackmail,” or ille-

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gal extortion. What exactly is greenmail? Is it wrong? Is it legal? What are its effects on the market? What responses are there to greenmail?

This Article takes the position that greenmail essentially represents a healthy aspect of competition to keep entrenched corporate management honest. Rather than introducing economic distortions, greenmail serves as an important market signal of an unhealthy company. Greenmail should not be prohibited and greenmail income should be taxed at the standard tax rate for ordinary gains.

A. *History of Corporate Take-Overs*

Greenmail arose as a natural evolution of corporate takeovers. Prior to the 1960's, raiders sought to take over companies by proxy fights.¹ A proxy fight occurs when a raider tries to convince shareholders to vote in favor of the takeover.² Proxy fights are subject to the Securities Exchange Act of 1934.³ The 1934 Act requires disclosure of the "identity and background of the purchaser, the source of funds to be used for the purchase, the purchaser's plans to liquidate, merge, or make other major changes to the target company, and the number of shares owned and sought" to the Securities and Exchange Commission ("SEC") and to the issuer of securities.⁴ Trading target shares for raider securities is another route to accomplishing the same end, with this transaction being controlled by the Securities Act of 1933.⁵ Tender offerings by raiders of cash for targeted stock became popular in the 1960's and are covered by the Williams Act,⁶ which requires disclosure of tender offer information to the SEC and to the target company. In the 1980's, raiders realized that they could obtain cash payouts from management without even taking control of the target company. "Greenmail" describes this practice of inflating a stock's price by purchasing it on the open market and initiating a takeover bid while giving management the option to repurchase its shares from the raider above the already inflated price. This leads to an important question: Is greenmail just an elaborate form of pump and dump? The quick answer is "no." To answer that question fully we need an exact definition of greenmail.

1. Mark E. Crain, *Disgorgement of Greenmail Profits: Examining a New Weapon in State Anti-Takeover Arsenals*, 28 HOUSTON L. REV. 867, 871-72 (1991).

2. Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1074, 1078 (1990).

3. See 15 U.S.C. § 78n(a)-(e) (2006).

4. Crain, *supra* note 1, at 872.

5. See 15 U.S.C. §§ 77a-77kk (2006).

6. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as 15 U.S.C. §§ 78m(d)-(e), 78n (d)-(f) (2006)).

B. *Definition of Greenmail*

Greenmail occurs when a shareholder acquires a significant amount of a company's stock and then threatens to take over the company unless the purchaser's shares are bought back by the company at a premium.⁷ Greenmail payments represent a repurchase premium.⁸ Not all premium rate stock repurchases are considered suspect. For example, the decision to repurchase the shares of a company's founder or those shares held by a "white knight" are not considered inherently suspect.⁹ Should premium repurchases be prohibited generally? Founders already have stock options and, possibly, watered stock. Why should premium repurchases be allowed to "white knights," traders who are friendly to management, and not for raiders? The interests of the shareholders, not those of management, should control and, thus, if premium share repurchases are allowed as to founders or white knights, then they should also be allowed as to ordinary shareholders. To determine whether premium share repurchases should be allowed, we must consider the economic effects and theoretical justifications/critiques of greenmail.

C. *Theories of Greenmail*

One theory, the "management entrenchment" hypothesis, holds that management pays out greenmail to keep their own jobs.¹⁰ This is likely the case as management has an obvious self-interest in maintaining corporate control. Though management does have an interest in keeping their jobs, this does not necessarily cause a conflict of interest between management and ordinary shareholders. Therefore, greenmail ought not to be prohibited on the basis of a possible conflict of interest between shareholders and management. Shareholders have internal governance mechanisms, as well as the option of not buying into or selling out of companies with entrenched managers.

7. William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L.J. 845, 850 n. 16 (2005).

8. David Manry & David Stangeland, *Greenmail: A Brief History*, 6 STAN. J. L. BUS. & FIN. 217, 225 (2001).

9. "When a significant block of shares is repurchased from a particular (targeted) shareholder not as part of an announced repurchase program for general corporate purposes, the repurchase may occur at a substantial premium over the then-current market price. The premium thus represents beneficial terms not available to shareholders generally. Some premium targeted repurchases, such as those from heirs of firm founders, or from white knights who hold shares to protect a valued corporate partner from outside takeover interest, arouse little attention from nonparticipating shareholders." *Id.* at 220 (citations omitted).

10. Note, *Greenmail: Target Stock Repurchases and the Management-Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 (1985).

Another theory is that management makes greenmail payments to defend the "shareholder's interests."¹¹ According to this second view, management has inside information that is not reflected in the stock's price. Greenmail under this second view is paid to protect the ordinary shareholders' interests. Another view is that greenmail is paid to reduce the costs of litigation or opposition to management strategies.¹² Some economists argue that greenmail is justifiable as it distributes costs of policing management.¹³

The obvious self-interest of management to keep their jobs makes the management entrenchment hypothesis plausible. However, though greenmail payouts reflect management's self-interest, they also represent an ordinary function of competition in the marketplace for good managerial teams. Greenmail payouts are a penalty for mismanagement and a market signal. They are a healthy part of the creative destruction which is the very nature of capitalist competition.

D. *Economic Effects of Greenmail*

What are the economic effects of greenmail? Empirical studies of greenmail on stock price and of managerial motivation in paying greenmail have been mixed.¹⁴ Greenmail payments usually¹⁵ lead to a decline in the publicly-traded price of the stock. This is because management's opposition to takeovers is seen as a sign of expected poor future performance.¹⁶ Some think that shows that greenmail is generally not in the shareholders' interests.¹⁷ I disagree. Even if greenmail were not an important market signal and a healthy competitive incentive for the capital market, greenmail does not generally affect prudent investors in a targeted company. Shareholders are heterogenous

11. Christopher J. Bellini, *The Evolution of Greenmail: A Lawyer's Dilemma in Corporate Representation*, 2 GEO. J. LEGAL ETHICS 533, 535-36 (1988).

12. "According to the 'management entrenchment' hypothesis, the management of a firm resorts to greenmail as a takeover defense principally to save their own jobs. Alternatively, the 'shareholders' interests' hypothesis defends greenmail; the management of a firm presumably possesses private information concerning underlying values which the new investors have uncovered through costly investigation. Greenmail may then represent the rejection by management of an inadequate offer. Another view is that management may be ridding the firm of disruptive shareholders, ending costly litigation, or reducing dissident opposition to management strategies." Manry & Stangeland, *supra* note 8, at 220.

13. Note, *supra* note 10, at 1055.

14. Bellini, *supra* note 11, at 540.

15. For a history of empirical studies on greenmail's effect on stock prices, see Manry & Stangeland, *supra* note 8, at 222.

16. *Id.* at 224.

17. "When news of a greenmail payment is announced, however, the stock price typically falls. The price declines are generally interpreted as evidence that these repurchases are inconsistent with shareholders' interests." *Id.* at 221 (citations omitted).

— each is in a different position. When the raider starts buying stock in the target company, the stock's price will generally rise. Some shareholders will sell and cash in on a windfall profit. Still others will hold out and then gladly buy the suddenly undervalued stock after the greenmail has been paid. In other words, just as the economic studies yield mixed results, so too are the effects of greenmail on individual shareholders unpredictable. Even if takeover rumors always lead to inflation of a stock price, and even if greenmail payments always lead to a reduction of the stock's publicly-traded price, the market, including prudent investors, can take all of that into account. Greenmail is just one more example of self regulation of the market through competition. Further, if greenmail weeds out bad management, which it likely does, then it is good for the economy.

Greenmail weeds out bad management. “[F]irms paying greenmail have above-average management turnover in the following year.”¹⁸ Moreover, greenmail is not effective as a tactic to prevent a hostile takeover. For example, the St. Regis Co. paid greenmail twice; the third takeover bid resulted in the sale to a white knight.¹⁹ Though greenmail is not an effective tool for entrenching management, and is unproblematic for that reason too, greenmail is an effective way to threaten entrenched and inefficient managers. Greenmail isn't a problem. It's a solution.

In other words, greenmail is more than just an elaborate “pump-and-dump” scheme. True, the takeover bid generally increases the price of the stock on the open market. Likewise, the greenmail payout generally results in “falling stock prices.” So what? That's completely normal — it's called the law of supply and demand. Even if that weren't the case, regulators must remember: management can always “just say no” and refuse to pay greenmail. Raiders take on a significant risk in hopes of a correspondingly significant reward; they aren't always right. The good business with bad management may turn out to be a bad business with good management capable of ferocious resistance for little or no reward. Second, management, especially entrenched and inefficient management, deserves to be threatened with a takeover when it is ineffective. Greenmail is just one more instance of capitalist competition leading to best performance.

18. *Id.* at 223.

19. Bellini, *supra* note 11, at 539.

II. RESPONSES TO GREENMAIL

To the extent that greenmail represents ordinary competition it does not need a remedy. Responses to greenmail are essentially anticompetitive. Because greenmail has a healthy function in the market, it is unsurprising that greenmail is not considered to be the crime of extortion, or any crime at all.²⁰ Greenmail is not extortion because there is no unlawful obtention of property²¹ and because management does not have the right to be free from the threat of a hostile takeover.²² Courts recognize the competitive function of corporate raiding.

A. Corporate Responses

1. Greenmail Payments are Lawful and Subject to the Business Judgment Rule

The decision of management to pay out greenmail is permitted as an instance of business judgement. The "business judgement rule" essentially holds that courts will not second guess the lawful decisions of management by allowing for various causes of actions, such as the tort of "negligent management."²³ However the business judgement rule is modified in the law of Delaware, New York, and California to take into account the conflict of interest between managers and shareholders.²⁴ Each of those states require management to prove there is some rationale justifying its decision.²⁵ California requires the inherent fairness of the transaction to be shown.²⁶ New York requires the justification be not merely arguable, but also plausible.²⁷ Delaware requires that the transaction be arguably in the shareholders' interest.²⁸ Delaware permits greenmail payments provided the purpose of management is not self-entrenchment;²⁹ however, in doing so, it requires an enhanced business judgement inquiry. Some "factors that the board of directors should analyze include: the inadequacy of the price offered, the nature and timing of the offer, questions on illegality, the impact

20. Stuart P. Green, *Theft by Coercion: Extortion, Blackmail, and Hard Bargaining*, 44 WASH. BURN L.J. 553, 577 (2005).

21. *Viacom Int'l, Inc. v. Icahn*, 747 F. Supp. 205 (S.D.N.Y. 1990).

22. *Id.* at 213-14; *Chock Full O'Nuts Corp. v. Finkelstein*, 548 F. Supp. 212 (S.D.N.Y. 1982). See also *Dan River, Inc. v. Icahn*, 701 F.2d 278 (4th Cir. 1983).

23. Bellini, *supra* note 11, at 546.

24. *Id.* at 552.

25. *Id.* at 552-53.

26. *Id.* at 553.

27. *Id.*

28. Bellini, *supra* note 11, at 553.

29. *Id.* at 546.

on constituencies other than shareholders, the risk of nonconsummation, and the quality of securities being offered in the exchange."³⁰

2. Charter/By-Law Amendment

Within the logic of capitalist competition and freedom of contract it is clear that the principal response to greenmail should be made by the company and not the state. Shareholders can and do amend corporate charters to prohibit greenmail. Amendments to corporate charters, unlike greenmail payments, do not result in a decline in stock prices.³¹ International Minerals & Chemicals, Perkin-Elmer, Mobil Oil, and many other companies have written anti-greenmail provisions into their charters or bylaws.³² Thus, there is little reason for state intervention to prevent greenmail.³³ Government regulation of corporation charters reduces shareholders' investment choices.³⁴

B. State Responses

1. Disgorgement

Another response to greenmail is disgorgement statutes which require remittance of greenmail payments. Critics point out that disgorgement reduces competition, diminishes shareholder participation, and depresses stock values.³⁵ I would argue they also represent a restraint on trade and a form of protectionism subject to antitrust law.

2. Anti-Takeover Laws

Some states have introduced anti-takeover statutes. State anti-takeover statutes have been challenged as unconstitutional on the basis of both the supremacy clause, alleging inconsistency with the Williams Act,³⁶ and the dormant commerce clause³⁷ with mixed results.³⁸ The

30. *Id.* at 547.

31. David Manry & David Stangeland, *Greenmail: A Brief History*, 6 STAN. J. L. BUS. & FIN. 217, 223 (2001).

32. Christopher J. Bellini, *The Evolution of Greenmail: A Lawyer's Dilemma in Corporate Representation*, 2 GEO. J. LEGAL ETHICS 533, 537-38 (1988).

33. Subcommittee on Annual Review, *Annual Review of Federal Securities Regulation*, 40 BUS. LAW. 997, 1020 n. 70. (1985).

34. Bellini, *supra* note 32, at 539.

35. Mark E. Crain, *Disgorgement of Greenmail Profits: Examining a New Weapon in State Anti-Takeover Arsenals*, 28 HOUSTON L. REV. 867, 869 (1991).

36. The Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2006), requires disclosure of stock purchases greater than 5% of a given class of stock. A state statute in conflict with the Williams act would be invalid due to the supremacy of federal law.

37. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 87-88 (1987).

Williams Act³⁹ requires disclosure to the SEC and the target company when a shareholder acquires more than 5% of a company. A state anti-takeover statute cannot conflict with the Williams act.⁴⁰ That is, the state anti-takeover statute must be consistent with federal law. State anti-takeover laws have also been made for reasons of protectionism,⁴¹ which raises the question of their compliance with the WTO. Competition among states may be the best way to determine the best regulatory response to greenmail and hostile takeovers.

C. Federal Responses

1. Taxation

In 1987, Public Law Number 100-203, Sec. 10228(c) established Internal Revenue Code Chapter 54, Section 5881, entitled "Greenmail".⁴² Title 26 of the United States Code, Section 5881 (I.R.C. § 5881) imposes a 50% tax on greenmail payments.⁴³ Greenmail payments can be in any form, or "consideration."⁴⁴ Greenmailed shares must have been held for less than two years.⁴⁵ The sale of stock must be in connection with a public tender offer.⁴⁶ As well, the greenmail payment must be differential, that is it must be made on terms other than are available to all other shareholders.⁴⁷ Public tender offers are those offers to purchase stock or assets which would be required to be filed or registered with federal or state regulatory agencies.⁴⁸ The tax applies whether or not gain is recognized.⁴⁹

The SEC permits greenmail payments because greenmail payments are taxed at a higher rate than other income. Coupled with the possibility to amend the corporate charter, the SEC sees no reason for federal intervention.⁵⁰

38. Compare *id.* at 87-94 (holding an anti-takeover statute was valid) with *Edgar v. MITE Corp.*, 457 U.S. 624, 631-40 (1982) (plurality opinion) (holding an anti-takeover statute was invalid).

39. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2006).

40. See *Edgar*, 457 U.S. at 631-32.

41. Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991).

42. David Manry & David Stangeland, *Greenmail: A Brief History*, 6 STAN. J. L. BUS. & FIN. 217, 227-28 (2001). Section 5881 was further modified in 1988. *Id.*

43. I.R.C. § 5881(a) (2006).

44. *Id.* § 5881(b).

45. *Id.* § 5881(b)(1).

46. *Id.* § 5881(b)(2).

47. *Id.* § 5881(b)(2)(C).

48. I.R.C. § 5881 (c)(1) (2006).

49. *Id.* § 5881 (d).

50. Bellini, *supra* note 32, at 555.

2. RICO/Hobbs Act (Extortion)

Critics of greenmail sometimes propose that it should be covered by the federal Racketeering Influenced and Corrupt Organizations Act (RICO) or by the Hobbs Act. To obtain a civil RICO remedy under Section 1962 of the United States Code, plaintiffs must prove: “(1) a person (2) through a pattern (3) of racketeering activity (4) directly or indirectly (a) invested in, (b) acquired or maintained an interest in, (c) or participated in (5) an enterprise (6) that affects or engages in interstate commerce and (7) causes injury thereby.”⁵¹ Proving wrongful injury, of course, is not really possible. Stock prices are always speculative. Management and ordinary shareholders have a conflict of interest. Likewise the Hobbs Act does not seem applicable. The Hobbs Act⁵² has two elements: obstruction of interstate commerce and robbery or extortion.⁵³ However, greenmail is not extortion; thus, the Hobbs Act cannot apply. Again, even if there was a problem, this really isn’t an appropriate remedy.

III. CONCLUSION

Corporate takeovers ensure competition among managers to be efficient and effective businessmen. Greenmail is one incentive for managerial competition. Thus, greenmail is not itself problematic; it is just one more mechanism of efficiency through competition. Greenmail is not an effective tool for managerial self-entrenchment. However, the speculative impact of greenmail is good for the economy since it highlights companies which are poorly managed and overvalued on the public market. By threatening bad managers of good companies, and by reallocating capital to efficient actors, greenmail strengthens the economy. Thus, most of the responses to greenmail are attempts to remedy a non-problem.

The most effective remedies, consistent with the capitalist logic of competition and individualism, are at the corporate level. A prudent corporation can foresee the possibility of a hostile takeover and amend its articles of incorporation and bylaws to protect itself. Improvident corporate managers probably deserve the risk of takeover that they incur by using shoddy “off the shelf” charters and bylaws. “Mom and pop” organizations must eventually grow up or sell out to more efficient operations. Further, the individual remedy is also effec-

51. Tracy Greer, *The Hobbs Act and RICO: A Remedy for Greenmail?*, 66 *TEX. L. REV.* 647, 653 (1988).

52. 18 U.S.C. § 1951(a) (2006).

53. Greer, *supra* note 51, at 662.

tive at the shareholder level. Selling stock when there is a takeover rumor and buying the now (supposedly) undervalued stock in the aftermath of the payout are rational investor actions that require no inside information. SEC reporting requirements and shareholder diligence remove the risk of insider trading.

Individual and corporate responses are adequate and best. Mercifully, state neo-mercantilist efforts at regulating takeovers are constrained by regulatory competition and federal supremacy. Thus many state anti-takeover statutes have been stricken as illegal.

And the federal response? The federal government imposes a heavy tax on greenmail, but taxes of 70% were once common. A 50% tax is onerous enough to discourage speculative greenmail, but not so great as to prevent raiders from threatening takeovers assuring management competition. In the interest of preventing economic distortion, it would be wiser to reduce the greenmail tax to the maximum corporate rate, allow greenmail payments to be characterized as ordinary and necessary business expenses (that are to be deducted from taxable income), and allow the greenmail payout to be treated as ordinary income, and thus able to be offset by any losses. Such minor tax reforms will occur to the extent that takeovers become correctly perceived as one more instrument of economic competition ensuring efficient markets and good economic performance.